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# THE CHALLENGE OF FIDUCIARY REGULATION: THE INVESTMENT ADVISERS ACT AFTER SEVENTY-FIVE YEARS

Roberta S. Karmel\*

## ABSTRACT

*Seventy-five years after its enactment the Investment Advisers Act of 1940 has advanced from a relatively weak statute merely registering advisers with the Securities and Exchange Commission (SEC) to a more robust law imposing fiduciary responsibilities on advisers. Over the years, the number of investment advisers and the number of their clients have increased greatly. The SEC therefore has been pressured by Congress to develop a harmonized fiduciary standard for broker-dealers and advisers and also to develop and enforce a greater degree of oversight over the advisory industry. These developments have raised the questions of how to fund such efforts and whether advisers should organize a self-regulatory organization. In the meantime, the Department of Labor adopted a fiduciary standard that will impact many broker-dealers and investment advisers. Further, the SEC has beefed up its examinations program for advisers and has become more aggressive in its enforcement of cases against advisers.*

## INTRODUCTION

When I was invited to submit an article for an issue of the *Brooklyn Journal of Corporate, Financial & Commercial Law* celebrating its tenth anniversary, I decided it was appropriate to write about the seventy-fifth anniversary of the Investment Advisers Act of 1940 (Advisers Act),<sup>1</sup> with best wishes to the *Journal* and hopes it will one day reach its seventy-fifth birthday. I was proudly present at the inauguration of this journal, but not the enactment of the Advisers Act, as I was only three years old on August 22, 1940 when it was passed. There were no headlines about the Advisers Act on that day, at a time when the country was considering entering World

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1. Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1–88b-21 (2012)).

War II. Rather, the news reported a British coastal convoy that came under fire from German cross-channel guns for the first time and a secret U.S. government scheme to send warships to Great Britain.<sup>2</sup> Also featured was a story about the murder of Leon Trotsky.<sup>3</sup>

As the last of the New Deal securities laws that date between 1933 and 1940,<sup>4</sup> the Advisers Act was probably the least considered and the least important. It was a weak statute, which accomplished little more than creating a registration list of investment advisers. Yet, over the years, it has been repeatedly amended at the urging of the U.S. Securities and Exchange Commission (SEC) and has become a more viable regulatory framework for investment advisers. In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)<sup>5</sup> expanded the coverage of the Advisers Act to require hedge funds and private equity funds to register with the SEC. Part I of this Article will set forth the legislative history of the Advisers Act and its amendments. This Part will also cover the changed population of investment managers, and suggest that investment management regulation has become an increasingly important public policy issue since 1940 due to the increase in retail investors as clients of advisers, and the growth of individual retirement accounts (IRAs). Although the Advisers Act has become a more robust regulatory tool, the challenges of fiduciary regulation have become more difficult.

The changed population of investment advisers' clientele has led to serious controversies as to whether the SEC should pass a harmonized fiduciary standard for broker-dealers and investment advisers, especially in view of the U.S. Department of Labor (DOL) regulation setting forth a fiduciary standard for accounts subject to the Employee Retirement Income Security Act of 1974 (ERISA).<sup>6</sup> It is unlikely that either of these controversies will be resolved by the time this Article is published. Part II of the Article will describe the status of these fiduciary rules, and express my view that a principles-based fiduciary standard is preferable to rules-

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2. *British Warned to Keep Alert for Real Blitz: Whole Town Shaken by Torpedo Blast*, CHI. TRIB., Aug. 22, 1940, at 1.

3. *Quiz American Girl About Slayer as He Confesses*, CHI. TRIB., Aug. 22, 1940, at 1.

4. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)); Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78pp (2012)); Trust Indenture Act of 1939, Pub. L. No. 76-253, 53 Stat. 1149 (codified as amended at 15 U.S.C. §§ 77aaa–77bbbb (2012)); Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80b-1–80a-64 (2012)).

5. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

6. Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Adviser, 81 Fed. Reg. 20,945 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509, 2510, 2550); Employee Retirement Income Security Act (ERISA) of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001–1191c, 1201–1242, 1301–1461 (2012)).

based regulation, but a self-regulatory organization (SRO) for investment advisers might be necessary to administer such a standard.

As frequently occurs when the SEC is unable to engage in rulemaking, it has attempted to impose its views concerning proper conduct upon investment managers through enforcement actions. Part III will discuss recent SEC enforcement activity in this area. Some recent enforcement cases repeat prior SEC concerns, but some relate to new problems. Part IV will conclude that a fiduciary rule for adviser accounts eventually will likely be passed by either the SEC or another agency, but that such a rule will not solve the conflict of interest problems facing investment managers, and therefore increased SEC enforcement actions against advisers is expected.

## I. LEGISLATIVE HISTORY OF THE ADVISERS ACT

### A. PASSAGE OF THE ADVISERS ACT

The Advisers Act was a by-product of the five-part report that the SEC provided to Congress between 1939 and 1941 entitled *Investment Trusts and Investment Companies*.<sup>7</sup> In conjunction with this five-part report, the SEC also provided six supplemental reports to Congress, the second of which is titled *Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services* (Investment Counsel Report), highlighting the SEC's concerns with the investment adviser industry.<sup>8</sup> The problems recognized were: distinguishing bona fide investment counsel from tipsters; conflicts of interest; contingent compensation tied to a percentage of profits; adviser custody of client assets and capitalization of the adviser entity; and assignment of client relationships.<sup>9</sup> These findings prompted the introduction of identical bills in the House of Representatives and the Senate that led to four weeks of hearings with intense opposition from the investment adviser industry.<sup>10</sup> In particular, the industry resisted the negative characterization of abusive practices by industry members, which were later stricken from the bill.<sup>11</sup>

The House Report stated that: "[t]he essential purpose of [the Advisers Act] is to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment

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7. U.S. SEC. & EXCH. COMM'N, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES pts. I-IV (1939-1941); see also JAMES E. ANDERSON ET AL., INVESTMENT ADVISERS: LAW & COMPLIANCE § 2.02 (Matthew Bender, Rev. Ed., 2015).

8. See U.S. SEC. & EXCH. COMM'N, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 76-477 (2d Sess. 1939).

9. ANDERSON ET AL., *supra* note 7, § 2.02.

10. See H.R. REP. NO. 76-2639 (1940); S. REP. NO. 76-1775 (1940).

11. See generally *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the S. Comm. on Banking & Currency*, 76th Cong. (1940) [hereinafter *Investment Trusts and Investment Companies Hearings*].

adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful.”<sup>12</sup> David Schenker, the Chief Counsel of the SEC Investment Trust Study, described the Advisers Act to Congress by stating:

[The Act] does not attempt to say who can be an investment counselor . . . and does not even remotely presume to undertake to pass upon their qualifications. All we say is that in order to get some idea of who is in the business and what is his background, you cannot use the mails to perform your investment counsel business unless you are registered with us.<sup>13</sup>

Many years ago, when I was an SEC enforcement attorney, I brought an administrative proceeding to revoke the registration of a registered investment adviser. In response, through an attorney, the adviser claimed he could not file an answer to our complaint by reason of insanity. I was quite flummoxed and asked whether this was not a sufficient ground upon which to revoke his registration. I was told that the SEC does not pass on the qualification of advisers. Even after many amendments to the Advisers Act, this remains the case insofar as SEC registration is concerned. However, many advisers pass the Series 65 exam administered by the Financial Industry Regulatory Association (FINRA) on behalf of the North American Securities Administrators Association (NASAA), and others may become Certified Financial Planners or earn other designations from various nongovernmental organizations.<sup>14</sup>

Initially, the Advisers Act did not do much more than require advisers to register with the SEC, similar to the way Dodd-Frank now requires hedge funds to register.<sup>15</sup> The original legislation did not grant the SEC the power to review or even to require that regulated advisers keep books and records.<sup>16</sup> Just five years into the Advisers Act’s existence, it became readily apparent that the SEC needed more authority. The SEC was worried that the end of World War II would initiate a new wave of retail investment.<sup>17</sup> In a release alongside its report to Congress, the SEC stated:

If the experience of World War I is any guide, many persons will be solicited when this war ends to buy corporate securities with their excess cash and with the proceeds of their matured or redeemed bonds. Moreover, a marked increase in securities trading by uninformed and

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12. H.R. REP. NO. 76-2639.

13. *Investment Trusts and Investment Companies Hearings*, *supra* note 11, at 50 (statement of David Schenker, Chief Counsel, SEC Investment Trust Study).

14. See generally *Series 65 – Uniform Investment Adviser Law Examination*, FINRA, <http://www.finra.org/industry/series65> (last visited Mar. 23, 2016); *Become a CFP Professional*, CFP BOARD, <http://www.cfp.net/become-a-cfp-professional> (last visited Mar. 23, 2016).

15. See 17 C.F.R. pts. 275, 279 (2015).

16. See Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–88b-21 (2012).

17. Investment Advisers Act Release No. 39, 1945 SEC LEXIS 917 (Jan. 31, 1945) [hereinafter Release No. 39].

inexperienced investors will probably occur. . . . [O]ur experience warns us that some advisers may avail themselves of this opportunity for exploitation of the gullible.<sup>18</sup>

Furthermore, the SEC's fear of being inadequately equipped to combat investment adviser fraud was increased by frauds similar in kind to that committed by Robert J. Boltz of Philadelphia, who induced retail investors to entrust him with \$2.5 million by claiming to be a principal investor in a highly profitable investment trust that did not actually exist.<sup>19</sup> Boltz used the funds for his personal investment in speculative securities and commodities.<sup>20</sup> Eventually, after running from the law, he was apprehended and sentenced to twenty years in prison, the longest prison sentence handed down under the Securities Act of 1933 at the time.<sup>21</sup>

## B. 1960 AMENDMENTS

In 1945, the SEC presented Congress with a report detailing the Advisers Act's shortcomings, with proposals for amendments that would enable the SEC to more effectively regulate the investment adviser industry.<sup>22</sup> Congress did not take action on the report for fifteen long years, when it finally passed formal amendments to address the SEC's concerns in 1960.<sup>23</sup> The 1960 Amendments largely gave the SEC the power it sought in the 1945 report; namely, the power to require advisers to keep accurate books and records, and the power to inspect those records.<sup>24</sup> The Senate stated that the "prospect of an unannounced visit of a Government inspector is an effective stimulus for honesty and bookkeeping veracity."<sup>25</sup> Additionally, the SEC could deny or suspend an adviser's registration if he or she violated any of the securities laws generally.<sup>26</sup>

Due to this Congressional expansion of the SEC's power in 1960, the SEC became empowered to use the Advisers Act's antifraud provision in section 206 to bring actions against advisers engaged in fraudulent practices.<sup>27</sup> In 1963, the U.S. Supreme Court decided *SEC v. Capital Gains Research Bureau, Inc.*, giving the SEC support for its efforts.<sup>28</sup> In *Capital Gains*, the Court differentiated common law fraud from fraud committed by

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18. *Id.*

19. 1941 SEC ANN. REP. 7 pt. 8, at 217.

20. *Id.*

21. *Id.* at 217–18.

22. See Release No. 39, *supra* note 17.

23. See Act of Sept. 13, 1960, Pub. L. No. 86-750, 74 Stat. 885 (amending certain provisions of the Investment Advisers Act of 1940).

24. See S. REP. NO. 86-1760, at 4 (1960).

25. See *id.* at 3.

26. See *id.* at 5.

27. See *id.* at 4 (discussing the new enforcement powers of the SEC); Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2012).

28. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194–95 (1963).

investment advisers. The Court concluded that common law fraud was borne out of arms-length commercial transactions.<sup>29</sup> In contrast, it found that the investment adviser relationship is one involving a preexisting “affirmative duty of [the] ‘utmost good faith.’”<sup>30</sup> This standard not only involves an obligation to act in good faith, but also to disclose all material facts and “‘to employ reasonable care to avoid misleading’ . . . clients.”<sup>31</sup> Armed with the *Capital Gains* decision, the SEC set out to tackle three problems that persisted in the investment adviser industry: “scalping,” usurping client investment opportunities, and conflicts of interest.<sup>32</sup>

“Scalping” is a practice whereby investment advisers purchase thinly-traded securities before issuing formal recommendation reports to clients, who in turn purchase the recommended securities resulting in price appreciation, allowing the investment advisers to cash out with substantial gains.<sup>33</sup> It is the exact practice at issue in the *Capital Gains* case. Nevertheless, the practice was widespread in the industry at the time, and the *Capital Gains* decision did not instantly eradicate it. The SEC pursued other fraudsters using section 206, emboldened by the Supreme Court’s imposition of a formal fiduciary duty.<sup>34</sup>

Between the 1960s and 1980s, the SEC became more forceful with its use of section 206, not only to eradicate practices like scalping, but also to eliminate *any* conduct it felt was inconsistent with the *Capital Gains* fiduciary duty standard.<sup>35</sup> This aggressive stance on section 206 was highlighted when the SEC began to take a closer look at investment advisers personally investing in securities that were appropriate for their clients’ portfolios in the 1990s.<sup>36</sup> For example, the SEC instituted an enforcement action against Joan Conan in 1994, alleging that she personally invested in securities that were well suited for the investment companies she advised.<sup>37</sup> Having been presented with a “conflict between her personal gain and the financial interests of the [f]unds,” the SEC found that Conan defrauded the investment companies by not disclosing the opportunity to purchase the securities and failing to obtain the companies’ consent, either prior to or following her purchase of the securities.<sup>38</sup> The decision in *Conan*

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29. *See id.*

30. *Id.* at 194 (quoting WILLIAM LLOYD PROSSER, *HANDBOOK OF THE LAW OF TORTS* 535 (1955)).

31. *Id.* (quoting 1 HARPER & FLEMING JAMES, JR., *THE LAW OF TORTS* 541 (1956)).

32. *See generally* Barry P. Barbash & Jai Massari, *The Investment Advisers Act of 1940: Regulation by Accretion*, 39 RUTGERS L.J. 627 (2008).

33. *Capital Gains*, 375 U.S. at 181.

34. *See, e.g., infra* note 35.

35. *See, e.g.,* Fred Alger Mgmt., Inc., Investment Company Act Release No. 17,358, Investment Advisers Act Release No. 1222, 45 SEC Docket 790, 791–92 (Feb. 26, 1990).

36. Barbash & Massari, *supra* note 32, at 634.

37. Conan, Exchange Act Release No. 34,756, Investment Advisers Act Release No. 1446, 57 SEC Docket 1952, 1954 (Sept. 30, 1994).

38. *Id.*

makes clear that the SEC views section 206 as creating a fiduciary standard of conduct for registered advisers; a duty that imposes a disclosure requirement that the adviser must inform the client if or when he or she is “taking an investment opportunity appropriate for a client.”<sup>39</sup> *Conan* also appears to assert that advisers’ employees are also subject to this disclosure requirement.<sup>40</sup>

Within a month of the *Capital Gains* case, the SEC used section 206 to bring an enforcement action against a registered adviser for breaching its fiduciary duty by providing partial investment advice to clients.<sup>41</sup> The SEC alleged that Chancellor Capital Management, and its principal, Parag Saxena, recommended that clients invest in the securities of start-up companies that were consulting clients and in which Mr. Saxena owned numerous securities, especially stock options.<sup>42</sup> Although Mr. Saxena had received clearance from Chancellor Capital’s legal department to exercise his stock options, the SEC found the Mr. Saxena’s fiduciary duty required him to disclose his positions to the firm and its clients before exercising the options.<sup>43</sup> In bringing an enforcement action against both Chancellor Capital and Mr. Saxena under section 206 of the Advisers Act, the SEC said that Mr. Saxena’s ownership in the start-up companies created a conflict of interest with the clients of Chancellor Capital.<sup>44</sup> In recommending investments in those companies on behalf of clients in contravention of Chancellor Capital’s policies and without disclosing the conflict of interest to clients, the SEC said that both Mr. Saxena and Chancellor Capital violated their fiduciary duties and section 206.<sup>45</sup> As a result of the section 206 violation, Mr. Saxena was forced to pay a fine of \$250,000, and Chancellor Capital was forced to pay a fine of \$500,000.<sup>46</sup>

### C. SUBSEQUENT AMENDMENTS—THE 1970S THROUGH 2002

During the period from 1970 to 2002, amendments to the Advisers Act occasionally closed loopholes in SEC regulations, while also occasionally opening new ones, reflecting the deregulatory philosophy of the time. The 1970 amendments to the Advisers Act were enacted in conjunction with more extensive changes to the Investment Company Act of 1940.<sup>47</sup> In 1969, Senate Report 184 specified two purposes for these amendments. The first

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39. Barbash & Massari, *supra* note 32, at 635.

40. *Id.*

41. Chancellor Capital Mgmt., Inc., Investment Advisers Act Release No. 1447, 57 SEC Docket 2204, 2205 (Oct. 18, 1994).

42. *Id.*

43. *Id.* at 2210.

44. *Id.*

45. *Id.*

46. Barbash & Massari, *supra* note 32, at 638 n.63.

47. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (codified as amended in scattered sections of 15 U.S.C.).



was to close an exemption allowing some advisers to investment companies to avoid registration.<sup>48</sup> The second purpose was to strengthen disciplinary controls over investment advisers.<sup>49</sup> This was largely accomplished by defining the term “person associated with an investment adviser” and adding language to grant the SEC the authority to take disciplinary action against these individuals.<sup>50</sup>

The 1970 amendments also gave the SEC authority to grant exemptions from the various provisions of the Advisers Act, “if and to the extent such exemption is . . . in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Act].”<sup>51</sup> The amendments granted advisers the ability to contract for customized fee structures, such as fulcrum fees, with certain investment companies and wealthy investors.<sup>52</sup> Finally, the 1970 amendments imposed liability on investment advisers for failure to supervise their employees and other persons under their supervision with an objective of preventing violations of the securities and financial laws.<sup>53</sup> This requirement is substantially identical to the provision imposing supervisory responsibility on broker-dealers under the Securities Exchange Act of 1934.<sup>54</sup>

Further amendments in the 1980s and 1990s clarified various provisions of the Advisers Act and adjusted its provisions to make them compatible with amendments to other federal securities law statutes.<sup>55</sup> An amendment in 1996 divided the authority to register advisers between state regulators and the SEC, and limited the states’ ability to require registration of advisory personnel.<sup>56</sup> It also permitted advisers to charge performance fees to foreign clients and privately offered investment funds, granted the SEC the authority to disqualify convicted felons, and provided for greater investor access to disciplinary information about advisers and their associated persons.<sup>57</sup>

In 1999, Congress enacted significant financial reform legislation in the form of the Gramm-Leach-Bliley Act (GLB),<sup>58</sup> which paved the way for

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48. See S. REP. NO. 91-184, pt. J, at 44 (1969).

49. *Id.*

50. See Investment Advisers Act of 1940 § 203(e)–(f), 15 U.S.C. § 80b-3(e)–(f) (2012).

51. *Id.* § 206A; see also S. REP. NO. 91-184, at 46.

52. See, e.g., 17 C.F.R. § 275.205-2(c) (2015). In a fulcrum fee arrangement, the adviser’s fee is determined based on the account’s performance as compared to an agreed-upon index.

53. See Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 23, 84 Stat. 1413, 1430 (amending section 202(a) of the Investment Advisers Act of 1940).

54. Securities Exchange Act of 1934 § 15(b)(4)(E), 15 U.S.C. § 78o(b)(4)(E) (2012).

55. See Investment Company Amendments Act of 1970, Pub. L. No. 91-577, 94 Stat. 2275 (codified as amended in scattered sections of 15 U.S.C.); National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified in scattered sections of 15 U.S.C.).

56. National Securities Markets Improvement Act § 303.

57. *Id.* § 310.

58. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 and 15 U.S.C.).

new affiliations between banks and securities firms, insurance companies, and other members of the financial services industry. The GLB Act also made changes to the Advisers Act. In particular, the GLB Act amended the definition of “investment adviser” so that banks and bank holding companies providing investment advisory services to investment companies would be brought under the jurisdictional umbrella of the SEC and the Advisers Act.<sup>59</sup> This revision did not impact the Advisers Act exemption for banks that provide investment advisory services to those entities that are not investment companies. The GLB Act also included a novel privacy mandate for all financial institutions.<sup>60</sup>

In 2000, Congress passed the Commodity Futures Modernization Act (CFMA), thereby amending the Commodity Exchange Act.<sup>61</sup> While the statute did not affect investment advisers, it did add section 203(b)(6) to the Advisers Act, providing that certain commodity trading advisers registered with the Commodity Future Trading Commission (CFTC), whose businesses do not primarily consist of acting as investment advisers, are exempted from registering with the SEC under section 203(a) of the Advisers Act.<sup>62</sup> Shortly after passage of CFMA, a member of the SEC staff noted that both the SEC and the CFTC would need to engage in administrative rulemaking to establish criteria for determining whether an adviser is “primarily” in the business of providing investment advice or commodities trading advice.<sup>63</sup> The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)<sup>64</sup> added section 203(e)(9),<sup>65</sup> and corresponding revisions to section 203(f) of the Advisers Act.<sup>66</sup> Section 203(e)(9) provides that bars or final orders imposed by non-securities-financial regulators, including state and federal banking regulators, and state insurance regulators are a potential basis for adviser disqualification.

#### **D. THE MUTUAL FUNDS SCANDALS OF THE EARLY 2000S**

The most significant employment of section 206 arguably came in the early 2000s as the SEC, in conjunction with separate actions taken by the N.Y. Attorney General, sought to eradicate market timing investment in

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59. *See id.* § 217(a) (amending section 202(a)(11)(A) of the Investment Advisers Act of 1940).

60. *See id.* § 501.

61. *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763, 2763A-365 to -480 (codified in scattered sections of 7 and 15 U.S.C.).

62. *Id.* § 209(b) (amending section 203(b)(6)(A) of the Investment Advisers Act of 1940).

63. Paul Royce, Dir. of Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm’n, Keynote Address at the Third Annual IA Compliance Summit: Managing the Revolution (Mar. 26, 2001).

64. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, and 28 U.S.C.).

65. *Id.* § 604(b); Investment Advisers Act of 1940 § 203(e)(9), 15 U.S.C. § 80b-3(e)(9) (2012).

66. Sarbanes-Oxley Act § 604(c)(2); Investment Advisers Act § 203(f), 15 U.S.C. § 80b-3(f).

mutual funds, a practice that was rampant, particularly by hedge funds, from the late 1990s to 2004.<sup>67</sup>

“[M]arket timing” refers to an investment strategy through which an investor seeks to exploit arbitrage opportunities that arise from differences created by market movements against the once-a-day pricing of mutual funds shares. Most mutual funds registered under the Investment Company Act of 1940 follow the business convention of determining the price of their shares once a day, typically as of 4:00 p.m. Eastern time, the close of trading on the New York Stock Exchange, through a calculation based on the value of the fund’s holdings of securities. The securities or other instruments held by a mutual fund, however, may be valued more frequently than, or may trade at different times from, the mutual fund’s shares. This valuation discrepancy was especially prevalent with regard to after-hours trading in foreign markets. Because the identity of the holdings of a mutual fund are not required to be, and are generally not, disclosed on a real-time basis, an investor in the fund who receives specific information about these holdings can engage in linked purchase and redemption transactions in shares of the fund to take advantage of the differences in the daily calculated price of the mutual fund’s shares and the market prices of its holdings. The ability to engage rapidly in large purchase-and-redemption transactions can enhance an investor’s potential returns.<sup>68</sup>

From 2003 to 2005, the SEC brought several enforcement actions against funds engaged in this practice.<sup>69</sup> In notable cases such as *Alliance Capital Management*<sup>70</sup> and *Putnam Investment Management*,<sup>71</sup> the SEC found that hedge funds giving preferred clients preferential arrangements for market timing in exchange for investments violated section 206, even though market timing is not explicitly illegal.<sup>72</sup> In some cases, the funds asserted they were not engaging in market timing, when in fact they were doing so. Even if no representations about market timing were made, the practice had an unsavory flavor.

In the case of *Alliance Capital Management*, the SEC found that Alliance had arranged for over \$600 million in market timing in 2003.<sup>73</sup> One investor had singlehandedly peaked at \$220 million of timing capacity in certain Alliance mutual funds.<sup>74</sup> In exchange, it invested in hedge funds

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67. Barbash & Massari, *supra* note 32, at 646–47.

68. *Id.* at 645–46 (footnotes omitted).

69. *Id.*

70. Alliance Capital Mgmt., L.P., Investment Company Act Release No. 26,312, Investment Advisers Act Release No. 2205, 81 SEC Docket 2800 (Dec. 18, 2003).

71. Putnam Inv. Mgmt., LLC, Investment Company Act Release No. 26,255, Investment Advisers Act Release No. 2192, 81 SEC Docket 1913 (Nov. 13, 2003).

72. Barbash & Massari, *supra* note 32, at 647–49.

73. Alliance Capital Mgmt., L.P., Investment Advisers Act Release No. 2205A, Investment Company Act Release No. 26,312A, 81 SEC Docket 3401 (Jan. 15, 2004).

74. *Id.*

operated by the same portfolio managers overseeing the mutual funds.<sup>75</sup> Alliance agreed to settle the case for \$250 million without admitting or denying the allegations against it.<sup>76</sup>

### E. THE 2008 FINANCIAL CRISIS AND THE DODD-FRANK ACT

In the wake of the 2008 financial collapse and the Madoff Ponzi scheme,<sup>77</sup> there was a sense amongst regulators that the financial services industry was due for a major overhaul. Congress enacted Dodd-Frank in 2010 in an attempt to bring about widespread changes to the industry.<sup>78</sup> Right or wrong, the country placed much of the blame for the financial collapse on the financial services industry for recommending institutional and retail investment in worthless securities, particularly in mortgage-backed securities. Dodd-Frank's sweeping legislation contained provisions amending the Advisers Act.<sup>79</sup> Among other things, it expanded SEC registration requirements to cover certain advisers and directed the SEC to promulgate various rules under the Advisers Act.<sup>80</sup>

In 2011, the SEC formally adopted amendments to the Advisers Act prompted by Dodd-Frank.<sup>81</sup> The rules define key terms and provide

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75. *Id.*

76. *Id.*

77. Robert Lenzner, *Bernie Madoff's \$50 Billion Ponzi Scheme*, FORBES (Dec. 12, 2008, 6:45 PM), [http://www.forbes.com/2008/12/12/madoff-ponzi-hedge-pf-ii-in\\_rl\\_1212croesus\\_inl.html](http://www.forbes.com/2008/12/12/madoff-ponzi-hedge-pf-ii-in_rl_1212croesus_inl.html).

78. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

79. See generally *id.* tit. IV, 124 Stat. 1570; Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110, 75 Fed. Reg. 77,052 (proposed Dec. 10, 2010) (to be codified at 17 C.F.R. pts. 275, 279); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3111, 75 Fed. Reg. 77,190 (proposed Dec. 10, 2010) (to be codified at 17 C.F.R. pt. 275); Family Offices, Investment Advisers Act Release No. 3220, 76 Fed. Reg. 37,983 (June 29, 2011) (to be codified at 17 C.F.R. pt. 275); Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221, 76 Fed. Reg. 42,950 (July 19, 2011) (to be codified at 17 C.F.R. pts. 275, 279).

80. Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110, 75 Fed. Reg. 77,052, 77,053 (proposed Dec. 10, 2010) (to be codified at 17 C.F.R. pts. 275, 279); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3111, 75 Fed. Reg. 77,190, 77,190 (proposed Dec. 10, 2010) (to be codified at 17 C.F.R. pt. 275); Family Offices, Investment Advisers Act Release No. 3220, 76 Fed. Reg. 37,983 (June 29, 2011) (to be codified at 17 C.F.R. pt. 275); Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221, 76 Fed. Reg. 42,950, 42,951 (July 19, 2011) (to be codified at 17 C.F.R. pts. 275, 279).

81. Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110, 75 Fed. Reg. 77,052, 77,053 (proposed Dec. 10, 2010) (to be codified at 17 C.F.R. pts. 275, 279); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3111, 75 Fed. Reg. 77,190, 77,190 (proposed

exemptions for investment advisers from registration.<sup>82</sup> Namely, the rules define “venture capital funds” for purposes of the exemption for venture capital fund advisers;<sup>83</sup> define key terms used in determining who is an exempt “foreign private adviser”;<sup>84</sup> change the reporting requirements for both registered and unregistered investment advisers, including advisers to hedge funds and other private funds;<sup>85</sup> implement a new exemption for advisers to private funds with less than \$150 million in assets under management;<sup>86</sup> and define terms used in determining whether an adviser is eligible for SEC or state registration.<sup>87</sup>

#### F. A REPORT CARD ON THE STATUTE

Before moving on to other topics, it seems appropriate to go back to the purposes of the Advisers Act as articulated in the SEC’s Investment Counsel Report and ask if the concerns expressed have been adequately addressed.<sup>88</sup> These concerns were:

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Dec. 10, 2010) (to be codified at 17 C.F.R. pt. 275); Family Offices, Investment Advisers Act Release No. 3220, 76 Fed. Reg. 37,983, 37,983 (June 29, 2011) (to be codified at 17 C.F.R. pt. 275); Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221, 76 Fed. Reg. 42,950, 42,950 (July 19, 2011) (to be codified at 17 C.F.R. pts. 275, 279).

82. *See generally* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110, 75 Fed. Reg. 77,052 (proposed Dec. 10, 2010) (to be codified at 17 C.F.R. pts. 275, 279); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3111, 75 Fed. Reg. 77,190 (proposed Dec. 10, 2010) (to be codified at 17 C.F.R. pt. 275); Family Offices, Investment Advisers Act Release No. 3220, 76 Fed. Reg. 37,983 (June 29, 2011) (to be codified at 17 C.F.R. pt. 275); Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221, 76 Fed. Reg. 42,950 (July 19, 2011) (to be codified at 17 C.F.R. pts. 275, 279).

83. 17 C.F.R. § 275.203(l)-1 (2015).

84. *Id.* § 275.202(a)(30)-1.

85. *Id.* § 275.204(b)-1.

86. *Id.* § 275.203(m)-1.

87. *Id.* § 275.203A-1. *See generally* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3110, 75 Fed. Reg. 77,052 (proposed Dec. 10, 2010) (to be codified at 17 C.F.R. pts. 275, 279); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3111, 75 Fed. Reg. 77,190 (proposed Dec. 10, 2010) (to be codified at 17 C.F.R. pt. 275); Family Offices, Investment Advisers Act Release No. 3220, 76 Fed. Reg. 37,983 (June 29, 2011) (to be codified at 17 C.F.R. pt. 275); Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221, 76 Fed. Reg. 42,950 (July 19, 2011) (to be codified at 17 C.F.R. pts. 275, 279).

88. *See* U.S. SEC. & EXCH. COMM’N, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 76-477, at 27–30 (1939).

### **1. Distinguishing Bona Fide Investment Counsel From “Tipsters”**

In general, a “tipster” is one who makes false or exaggerated statements about an investment under a false pretense of offering genuine investment advice.<sup>89</sup> In contrast, a bona fide investment counselor is one who renders personalized advice based on training and experience.<sup>90</sup> One could certainly argue that Madoff and other Ponzi scheme operatives of recent years were scandalous “tipsters.”

### **2. Possible Difficulties With Conflicts of Interest**

The Investment Counsel Report concluded that conflicts of interest arise when a broker recommends a stock that he or she has personally brought to market, or when a broker has a personal financial interest in a given transaction.<sup>91</sup> Corporate directorships held by investment counselors were seen as another possible conflict of interest.<sup>92</sup> Finally, the report identified the conflict generated when counselors trade for their own accounts’ securities.<sup>93</sup>

While the Advisers Act does not outlaw some of these specific conflicts, and conflicts of interest must be described in the Form ADV and delivered to clients, newer conflicts persist; for example, the sale of proprietary products by advisers in a financial-services holding company. In late 2015, the SEC sued First Eagle Investment Management, an asset management firm, for improperly billing its investors \$25 million in payments to brokers marketing its mutual funds shares, instead of paying the marketing costs itself.<sup>94</sup> It made these payments pursuant to Rule 12b-1 of the Advisers Act. I feel a little guilty about that as I was a commissioner in 1980 who favored adoption of this rule.<sup>95</sup>

### **3. Contingent Compensation Tied to a Percentage of Profits**

The Investment Counsel Report noted that contingent fee structures could incentivize investment advisers to take on unjustifiable risks that are potentially inconsistent with the best interest of a client.<sup>96</sup> An adviser faced little to no downside risk, but would enjoy increased payment if her

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89. *See id.* at 28.

90. *See id.*

91. *Id.*

92. *See id.* at 29.

93. *Id.* at 29–30.

94. *See* Gretchen Morgenson, *Dubious Marketing Fees Catch the Eye of the S.E.C.*, N.Y. TIMES, Sept. 27, 2015, at BU.1.

95. *See generally* Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11,414, 45 Fed. Reg. 73,898 (Nov. 7, 1980) (to be codified at 17 C.F.R. pts. 239, 270, 274).

96. *See* Morgenson, *supra* note 94.

speculation, or “churning,”<sup>97</sup> paid off. Although the Advisers Act initially outlawed contingent compensation, some contingent fees have crept into the Advisers Act, and hedge fund managers and some other asset managers not only charge contingent fees, but also fail to pay ordinary income taxes on “carried interest.”<sup>98</sup>

#### 4. Custody of Client Assets and Capitalization of the Adviser Entity

The Investment Counsel Report discovered that many investment advisers retained custody of client securities.<sup>99</sup> Such arrangements were viewed as being far too exposed to potential abuse. In addition, the question of minimum capitalization requirements for adviser entities and the absence of auditing requirements for investment advisers startled Congress.<sup>100</sup> The use of the corporate form to avoid personal liability amplified these problems.<sup>101</sup> It was only after the Madoff scandal that Congress tightened the provisions of the Advisers Act to require that a Certified Public Accountant (CPA) verify a client’s assets in an adviser’s custody,<sup>102</sup> however, advisers are still not subject to any capital adequacy rules similar to those imposed on other financial institutions.

#### 5. Assignment of Client Relationships

The Investment Counsel Report noted that advisers established in the corporate form could assign accounts, assets, and advisory services without seeking the consent of the client, all by merely transferring ownership of the adviser entity to third parties.<sup>103</sup> Section 205 of the Advisers Act has now prohibited such assignments without notification to clients.<sup>104</sup>

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97. According to the SEC website:

Churning occurs when a broker engages in excessive buying and selling of securities in a customer’s account chiefly to generate commissions that benefit the broker. For churning to occur, the broker must exercise control over the investment decisions in the customer’s account, such as through a formal written discretionary agreement. Frequent in-and-out purchases and sales of securities that don’t appear necessary to fulfill the customer’s investment goals may be evidence of churning.

*Fast Answers: Churning*, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/answers/churning.htm> (last modified Jan. 15, 2013).

98. See Owen Davis, *What is the Carried Interest Loophole?*, INT’L BUS. TIMES (Sept. 16, 2015, 1:53 PM), <http://www.ibtimes.com/what-carried-interest-tax-loophole-2100059>.

99. U.S. SEC. & EXCH. COMM’N, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 76-477, at 30 (1939).

100. See *id.*

101. See *id.*

102. 17 C.F.R. § 275.206(4)-2(a)(4) (2015).

103. H.R. DOC. NO. 76-477, at 30.

104. Investment Advisers Act of 1940 § 205(a)(2), 15 U.S.C. § 80b-5(a)(2) (2012); see also 17 C.F.R. § 275.206(4)-2(a)(2).

### G. THE CHANGED POPULATION OF ADVISERS AND THEIR CLIENTS

When the Advisers Act passed in 1940, there were only fifty-one advisory firms.<sup>105</sup> There are currently 11,600 advisory firms registered with the SEC.<sup>106</sup> This figure does not include those entities that are exclusively registered with the states.<sup>107</sup> SEC-registered advisers manage more than \$67 trillion of assets for more than fifteen million clients.<sup>108</sup> SEC-registered advisers reported in 2010 that approximately:

91.2% of their assets under management were in discretionary accounts, while 8.8% were in non-discretionary accounts. Approximately 63.9% of Commission-registered investment advisers reported that 51% or more of their assets under management related to the accounts of individual clients (other than high net worth individuals). Most investment advisers charge clients fees for investment advisory services based on the percentage of assets under management (over 95%). Others may charge hourly or fixed rates. Few investment advisers reported receiving commission-based compensation (8.9% of Commission-registered investment advisers). The majority of [SEC-registered] investment advisers (51.2%) reported that they have six or fewer non-clerical employees, and 91% reported that they have 50 or fewer employees.<sup>109</sup>

One of the reasons for the explosion in the number of investment advisory clients is the shift in retirement savings from defined-benefit pension funds of large corporations to defined-contribution plans. “The percentage of workers covered by a traditional defined-benefit pension plan that pays a lifetime annuity . . . has been steadily declining over the past twenty-five years.”<sup>110</sup> From 1979 to 2011, the proportion of private wage and salary workers participating in defined-benefit pension plans fell from 28 percent to 3 percent.<sup>111</sup> By contrast, the proportion of private wage and salary workers participating in only defined-contribution plans increased from 7 percent to 31 percent.<sup>112</sup> Even government entities are trying to reduce the drag of pensions on their budgets by shifting employees into defined-contribution plans. Thus, it can be anticipated that the growth of

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105. *SEC Chair Mary Jo White on IA Act's 75th Anniversary*, YOUTUBE (Aug. 19, 2015), <https://www.youtube.com/watch?v=G956jqFpWbQ>.

106. *Id.*

107. *Id.*

108. *Id.*

109. U.S. SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 7 (2011) [hereinafter SEC HARMONIZATION STUDY] (footnotes omitted).

110. Barbara A. Butrica et al., *The Disappearing Defined Benefit Pension and Its Potential Impact on the Retirement Incomes of Baby Boomers*, SOC. SEC. BULL., Oct. 2009, at 1, 1.

111. *FAQs About Benefits – Retirement Issues*, EMP. BENEFIT RESEARCH INST., <https://www.ebri.org/publications/benfaq/index.cfm?fa=retfaq14> (last visited Feb. 15, 2016) (see Figure 1).

112. *See id.*



investment funds under management by private advisers will continue to grow.<sup>113</sup>

These statistics highlight the growth of the investment advisory industry and provide a foundation for understanding the current controversies concerning the DOL's proposed fiduciary standard and the SEC's increasingly intense focus on the obligations of investment advisers.

## II. DEVELOPMENT OF A FIDUCIARY STANDARD

### A. DODD-FRANK MANDATES TO THE SEC

The issue of whether broker-dealers and investment advisers should be subject to a harmonized fiduciary standard when giving personalized advice to retail customers has been under consideration for years, at least since broker-dealers moved from a commission-based fee structure to an asset-based fee structure for brokerage customers after the unfixing of commission rates in 1975.<sup>114</sup> Dodd-Frank mandated that the SEC devote renewed attention to the development of a harmonized fiduciary duty regulation for investment advisers and broker-dealers, and gave the SEC the authority to harmonize the fiduciary standard for brokers, dealers, and investment advisers who provide personalized investment advice to customers.<sup>115</sup>

The Study on Investment Advisers and Broker-Dealers (Harmonization Study), released by the SEC staff in January 2011,<sup>116</sup> was required by Dodd-Frank to address whether there are regulatory gaps, shortcomings, or overlaps in legal or regulatory standards for broker-dealers, investment advisers, and their associated persons, whether imposed by the SEC, a national securities association, or other state or federal authorities.<sup>117</sup> Dodd-Frank specified that the SEC incorporate fourteen items in the Harmonization Study, including: whether retail customers understand the difference between the standards of care applicable to broker-dealers and investment advisers; the regulatory, examination, and enforcement resources available to enforce standards of care; whether a change in the standards would impact retail customers' access to products and services; the impact of eliminating the broker-dealer exclusion from the definition of "investment adviser" in the Advisers Act; and the potential additional costs

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113. See, e.g., PAULA SANFORD & JOSHUA M. FRANZEL, THE EVOLVING ROLE OF DEFINED CONTRIBUTION PLANS IN THE PUBLIC SECTOR 6 (2012).

114. See *Fin. Planning Ass'n v. SEC*, 482 F.3d 481, 485, 499 (D.C. Cir. 2007).

115. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 913(g), 124 Stat. 1376, 1828 (2010).

116. SEC HARMONIZATION STUDY, *supra* note 109.

117. Dodd-Frank Act § 913(b)(2) (mandating the Study and Rulemaking Regarding Obligations of Brokers, Dealers, and Investment Advisers).

to retail customers, broker-dealers, and advisers from changes in regulatory requirements.<sup>118</sup>

One difficulty with harmonizing a fiduciary duty standard is that there are many more investment advisers than broker-dealers, and some of the adviser firms are quite small. In contrast to the more than 11,000 advisers registered with the SEC, there are 5,100 broker-dealers registered with the SEC, less than 1,000 of which claim “that they engage in, or expect to engage in, investment advisory services.”<sup>119</sup> Approximately 5 percent of registered broker-dealers are now registered with the SEC as investment advisers, and 22 percent of SEC-registered advisers reported having a related person that was a broker-dealer; approximately 18 percent of broker-dealer members of FINRA had an affiliate engaged in advisory services.<sup>120</sup>

Much of the Harmonization Study is devoted to a recitation of the fiduciary duties applicable to investment advisers and the comparable duties applicable to broker-dealers by way of the shingle theory.<sup>121</sup> The SEC staff’s analysis of retail investor perceptions and confusion regarding financial service provider obligations and standard of conduct is based on years of studies by the SEC and outside providers.<sup>122</sup> The staff’s unsurprising conclusion is that “retail customers do not understand and are confused by the roles played by advisers and broker-dealers,” especially when broker-dealers are “providing personalized investment advice and recommendations about securities.”<sup>123</sup> Accordingly, the staff recommended that when personalized securities advice is given to retail customers, advisers and broker-dealers should be subject to a uniform fiduciary standard “that is no less stringent than currently applied to investment advisers” under the antifraud provisions of the Advisers Act.<sup>124</sup>

In analyzing the regulation of broker-dealers and investment advisers, the staff came up with a long list of gaps, shortcomings, and overlaps, including “disclosure; registration; licensing; competency and continuing education; obligation to act in the best interest of the customer; suitability; oversight and examination; supervision; advertising; books and records; [and] financial responsibility.”<sup>125</sup> Also of importance were discrepancies in investor remedies for fraud and other derelictions, and SRO membership and regulation.<sup>126</sup> The staff also pointed out that broker-dealer regulation tends to be rule-based, in part because of SRO interpretations of the shingle

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118. *Id.* § 913(c).

119. SEC HARMONIZATION STUDY, *supra* note 109, at 8.

120. *Id.* at 12.

121. See generally Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271 (1995).

122. SEC HARMONIZATION STUDY, *supra* note 109, at 93–101.

123. *Id.* at 101.

124. *Id.*

125. *Id.* at 104–05 (footnotes omitted).

126. *Id.*

theory, whereas the fiduciary duty of advisers tends to be principles-based.<sup>127</sup> The Harmonization Study therefore recommended that the SEC should engage in rulemaking to implement a harmonized standard for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers “to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.”<sup>128</sup>

One of the problems the SEC has faced in attempting to craft a uniform fiduciary standard for advisers and broker-dealers is the principal trading restrictions of section 206(3) of the Advisers Act.<sup>129</sup> This provision prevents an adviser from acting as principal in the sale of a security without disclosing to a client in writing before the completion of the transaction the capacity in which the adviser is acting and obtaining the client’s consent before effecting the transaction.<sup>130</sup> Although standards for dealing with retail customers by broker-dealers are not that different in other respects from the fiduciary duty standard of the Advisers Act, trade-by-trade disclosure and consent to principal trading by broker-dealer customers is unrealistic. If such consent had to be obtained, retail customers might be cut off from opportunities to invest in underwritings and certain other products. When confronted with having to impose such a duty on broker-dealers in the past, the SEC passed a temporary rule allowing broker-dealers to obtain blanket consent from customers in such situations, after making certain disclosures to their clients and thereafter providing them with an annual report of principal transactions.<sup>131</sup> With regard to this thorny topic, the Harmonization Study merely recommended that the SEC should give guidance or engage in rulemaking to address “how broker-dealers [should] fulfill the uniform fiduciary standard when engaging in principal trading.”<sup>132</sup>

Another difference between broker-dealer and investment adviser regulation is that there is no implied right of action for advisory clients against advisers, although clients can sue for return of their fees.<sup>133</sup> Broker-dealers are subject to damages for *fraudulent* practices or recommendations, but there are no express or implied provisions for liability in the Advisers Act giving rise to damages when advisers make *inappropriate* recommendations to clients.

At the time the Harmonization Study was issued, the SEC Commissioners were not in agreement concerning a harmonized fiduciary

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127. *Id.* at 103–04.

128. *Id.* at 109–10.

129. Investment Advisers Act of 1940 § 206(3), 15 U.S.C. § 80b-6(3) (2012); *see also* 17 C.F.R. § 275.206(3) (2015).

130. *See* Investment Advisers Act § 206(3); 17 C.F.R. § 275.206(3).

131. 17 C.F.R. § 275.206(3)-3T.

132. SEC HARMONIZATION STUDY, *supra* note 109, at 120.

133. *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 24 (1979).

standard. The two Republican Commissioners, Commissioners Casey and Paredes, dissented from the release of the Harmonization Study on the grounds that further studies needed to be completed to support its conclusions.<sup>134</sup> They expressed the view that the Harmonization Study failed to adequately justify its recommendations and did not identify whether retail investors were being harmed or disadvantaged by one regulatory regime compared to the other.<sup>135</sup> They also argued that the Harmonization Study did not appropriately account for the cost of implementing its recommendations.<sup>136</sup> Commissioner Aguilar, a Democrat, expressed the view that a uniform fiduciary standard might create a hardship on smaller investment advisers.<sup>137</sup> Given the lack of consensus at the SEC with regard to these issues, against the backdrop of the SEC's budget problems, the staff recommendations stalled.

The current SEC Chair has stated that the SEC will implement a harmonized fiduciary duty rule, but has given no timeline for any such proposal.<sup>138</sup> The DOL has now released a fiduciary duty rule for ERISA accounts, including 401(k) and IRA accounts,<sup>139</sup> and so even if the SEC adopts a harmonized fiduciary duty rule, it probably will not be harmonized with the DOL's rule.

## B. THE DEPARTMENT OF LABOR INITIATIVE

The DOL promulgates standards for any person deemed a "fiduciary" with respect to a benefit plan and is thereby subject to the fiduciary duty provisions of ERISA.<sup>140</sup> These standards derive from trust law and require a fiduciary to exercise a heightened degree of care, prudence, and diligence in their discretionary authority or control over a benefit plan, its participants, and beneficiaries.<sup>141</sup> Specifically, the primary fiduciary obligations under ERISA are: that plan assets be administered according to "the care, skill, prudence and diligence . . . [of a] prudent man";<sup>142</sup> the obligation to act

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134. Kathleen L. Casey & Troy A. Paredes, Comm'rs, U.S. Sec. & Exch. Comm'n, Statement by SEC Commissioners: Statement Regarding Study On Investment Advisers and Broker-Dealers (Jan. 21, 2011).

135. *Id.*

136. *Id.*

137. See Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Speech by SEC Commissioner: Setting Forth Aspirations for 2011 (Feb. 4, 2011).

138. See, e.g., Mark Schoeff Jr., *SEC's Mary Jo White Says Agency Will Develop Fiduciary Rule for Brokers*, INVESTMENTNEWS (Mar. 17, 2015, 12:31 PM), <http://www.investmentnews.com/article/20150317/FREE/150319919/secs-mary-jo-white-says-agency-will-develop-fiduciary-rule-for>.

139. Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Adviser, 81 Fed. Reg. 20,945 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509, 2510, 2550).

140. *Id.*; see also Employee Retirement Income Security Act (ERISA) Act of 1974, Pub. L. No. 93-406, § 404, 88 Stat. 829, 877–78 (codified at 29 U.S.C. § 1104 (2012)).

141. See 29 U.S.C. §§ 1002(3), 1002(7), 1002(8), 1002(21)(A)(i), 1104(a)(1) (2012).

142. *Id.* § 1104(a)(1)(B).

loyally, diversify plan investments, and follow plan documents;<sup>143</sup> and to refrain from various conflict-of-interest transactions.<sup>144</sup> DOL rules affect a large number of retirement plans and assets. Approximately \$24.7 trillion was invested in U.S. retirement-account assets as of the end of 2014.<sup>145</sup> Over half that amount, \$14.2 trillion, was invested in participant-directed accounts, such as 401(k) plans and IRAs.<sup>146</sup>

In 2010, the DOL proposed a new regulation on the definition of a fiduciary and the duties owed by such a person.<sup>147</sup> In view of the protracted, serious criticism of this proposal, the DOL promulgated a revised proposal on April 20, 2015.<sup>148</sup> The revised proposal also was subject to a variety of serious criticisms, one of which is that the DOL is intruding on the SEC's turf in crafting a fiduciary duty rule.<sup>149</sup> Analysis of the DOL proposal is beyond the scope of this Article, but the controversy regarding the proposal is pertinent to the SEC's effort to promulgate a harmonized fiduciary standard for investment advisers and broker-dealers, and some of the SEC's recent examination and enforcement programs.

The DOL asserts that its regulations require an adviser "to meet fundamental obligations of fair dealing and fiduciary conduct—to give advice that is in the customer's best interest; avoid misleading statements; receive no more than reasonable compensation; and comply with applicable federal and state laws governing advice."<sup>150</sup> This principles-based articulation of an adviser's fiduciary duty does not appear to be especially radical. Further, the DOL has created a "best interests contract exemption" for broker-dealers who service IRAs.<sup>151</sup> The Securities Industry and Financial Markets Association (SIFMA), the trade association for the securities industry, has proposed that FINRA adopt a best interest of the customer standard in lieu of its existing suitability rule.<sup>152</sup>

The barrage of criticism of the DOL's re-proposed fiduciary duty rule was fierce. Congress has made several attempts to halt, or at least seriously

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143. *Id.* § 1104(a)(1)(A), (C), (D).

144. *See id.* § 1106.

145. INV. CO. INST., 2015 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE U.S. INVESTMENT COMPANY INDUSTRY 137 (2015).

146. *See id.*

147. Definition of the Term "Fiduciary", 75 Fed. Reg. 65,263, 65,263 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. pt. 2510).

148. Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. 21,927, 21,928 (notice of proposed rulemaking and withdrawal of previous proposed rule Apr. 20, 2015) (to be codified at 29 C.F.R. pts. 2509, 2510).

149. *See* Daniel M. Gallagher, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks by Commissioner at: The SEC Speaks in 2015 (Feb. 20, 2015).

150. Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 80 Fed. Reg. at 21,929.

151. Best Interest Contract Exemption, 81 Fed. Reg. 21,002 (Apr. 8, 2016) (to be codified at 29 C.F.R. pt. 2550).

152. Press Release, Sec. Indus. & Fin. Mkts. Ass'n, SIFMA Proposes Best Interests Standard for Broker-Dealers (June 3, 2015).

delay, the issuance of a final rule.<sup>153</sup> Among the concerns of the critics of the DOL's regulation are that it could possibly give IRAs a route to sue advisers for faulty financial advice even though the DOL does not directly regulate IRAs.<sup>154</sup> Rather, IRAs are subject to the prohibited-transaction rules of the Internal Revenue Code<sup>155</sup> patterned on ERISA. The DOL regulation also extends the type of activities in which a broker-dealer might engage and therefore become a fiduciary, in particular giving advice with regard to the investment of IRA rollovers.<sup>156</sup>

The most commonly reiterated complaint, however, is that there should not be one set of DOL standards for ERISA, especially for IRAs, and another set of standards for the accounts of other SEC-registered brokers and advisers.<sup>157</sup> Although most sectors of the financial services industry have lined up in opposition of the DOL's proposal, there are also some significant lobbying groups, such as the Consumer Federation of America (CFA) and AARP, supporting the proposed rule.<sup>158</sup> This brouhaha has occurred, at least in part, because the SEC has been unable to garner a majority of commissioners to support a harmonized fiduciary standard for broker-dealers and investment advisers. There is also an apparent struggle between an executive-branch agency and the Obama-White House, and opposing congressional interests influencing the SEC, or at least some of its commissioners.

Although the DOL has now promulgated a fiduciary rule,<sup>159</sup> it is quite possible that the rule will be attacked by business groups in the courts and perhaps upended by the Circuit Court of Appeals for the District of Columbia.

### C. THE CREATION OF AN SRO FOR ADVISERS

Whether advisers should form an SRO is an issue of long standing in securities regulation. The possibility of creating an SRO for investment

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153. See, e.g., Mark Schoeff Jr., *New Bills Aim to Stop DOL Fiduciary Rule*, INVESTMENT NEWS (Dec. 18, 2015, 1:59 PM), <http://www.investmentnews.com/article/20151218/FREE/151219916/new-bills-aim-to-stop-dol-fiduciary-rule>.

154. *Commenters React to DOL's Proposed Expansion of Fiduciary-Duty Rule*, ROPES & GRAY (Aug. 17, 2015), <https://www.ropesgray.com/newsroom/alerts/2015/August/Commenters-React-to-DOLs-Proposed-Expansion-of-Fiduciary-Duty-Rules.aspx> [hereinafter *Expansion of Fiduciary-Duty Rule*].

155. I.R.C. § 4975 (2012).

156. U.S. DEP'T OF LABOR, FACT SHEET: DEPARTMENT OF LABOR PROPOSES RULE TO ADDRESS CONFLICTS OF INTEREST IN RETIREMENT ADVICE, SAVING MIDDLE-CLASS FAMILIES BILLIONS OF DOLLARS EVERY YEAR 2 (2015).

157. See *Expansion of Fiduciary-Duty Rule*, *supra* note 154.

158. Memorandum from the Consumer Fed'n of America on the Dep't of Labor Fiduciary Rule Proposal to the Office of Regulations & Interpretations, Office of Exemption Determinations, and Emp. Benefits Sec. Admin., U.S. Dep't of Labor 1 (July 21, 2015).

159. Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Adviser, 81 Fed. Reg. 20,945 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509, 2510, 2550).

advisers was raised as a recommendation in the SEC's 1963 Special Study of the Securities Markets.<sup>160</sup> In 1990, Congressmen Boucher, Dingell, and Markey sponsored a bill called the Investment Advisers Disclosure and Enforcement Act of 1990, which would have provided that advisers pay an annual fee to the SEC to finance their own oversight.<sup>161</sup> Then-Commissioner Mary Schapiro (and later Chair of the SEC) gave testimony on the proposed bill.<sup>162</sup> She contrasted direct oversight by the SEC with a system of self-regulation and stated that "direct regulation of advisers by the [SEC] is in many respects preferable to creating another regulatory system. However, the [SEC] cannot provide meaningful direct regulation of advisers without significant additional resources."<sup>163</sup> In my opinion, this remains true today.

A recommendation that an SRO be created for investment advisers was again taken up in the Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure (Blueprint) published in March 2008.<sup>164</sup> The Blueprint expressed the view that self-regulation of the investment advisory industry, rather than SEC regulation, would increase investor protection and be more cost-effective.<sup>165</sup> The Treasury reasoned that a "self-regulatory system can help to cover any gaps in federal regulation and can typically respond to market developments more quickly than can government oversight," because government regulators are mainly focused on antifraud enforcement, whereas SROs can adopt and amend industry rules that address a wider range of activity and professional conduct.<sup>166</sup> Further, an SRO can result in significant savings to taxpayers. An SRO's "private source of funding . . . may even be more flexible than that for governmental regulators, which typically depend upon Congress and an annual appropriation process," whereas an SRO can raise revenues through fees paid by its members.<sup>167</sup>

The CFA expressed opposing views on the advisability of implementing a self-regulatory system for investment advisers when Dodd-

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160. See U.S. SEC. & EXCH. COMM'N, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 88-95, at 158-59 (1963).

161. H.R. 4441, 101st Cong. (1990).

162. *Financial Services Industry: Hearings on H.R. 3054, H.R. 4441, and H.R. 5777 Before the Subcomm. on Telecomms. & Fin. of the H. Comm. on Energy & Commerce*, 101st Cong. 276 (1990) (statement by Mary Schapiro, Comm'r, U.S. Sec. & Exch. Comm'n).

163. *Id.* at 277.

164. See DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 106 (2008).

165. *Id.* at 113.

166. *Id.* at 122.

167. *Id.* at 123. The Blueprint also acknowledged some downsides of SRO regulation, by pointing out "the potential for redundant or duplicative regulatory burdens" and the conflict of interest arising from the financial interest an SRO may have in its members or their business activities. However, such potential problems can "be dealt with by structuring SROs as not-for-profit entities and requiring that a majority of an SRO's board members" are independent "and that investor interests are well represented." *Id.*

Frank was wending its way through Congress.<sup>168</sup> The CFA believed that investment service providers should be regulated according to what they do rather than what type of firm employs them.<sup>169</sup> In that regard, the CFA opposed designating FINRA as the SRO for investment advisers because that “[would] mean that investors [would have to] . . . swim against a strong tide of industry opposition in pushing reforms and that those reforms, when adopted, [would] tend to be timid and incremental in nature.”<sup>170</sup> Instead, the CFA endorsed the governance model of the Public Company Accounting Oversight Board (PCAOB) in order to ensure the independence of the contemplated SRO and the predominance of investor interests in the reforms adopted.<sup>171</sup>

By contrast, the Investment Adviser Association (IAA) opposed the creation of an SRO for the advisory profession, arguing that the SEC is an appropriate direct regulator of investment advisers.<sup>172</sup> The IAA indicated the following drawbacks to an SRO: inherent conflicts of interest; questions about transparency, accountability, and oversight; and added costs and bureaucracy.<sup>173</sup> The IAA particularly opposed the idea of FINRA as the SRO for investment advisers, given its governance structure, costs, track record, and advocacy of the broker-dealer model of regulation, reasoning that any harmonization of fiduciary standards should not result in subjecting investment advisers to inappropriate broker-dealer rules.<sup>174</sup> Instead of focusing on an SRO as the response to proper oversight of investment advisers, the IAA believed that Congress should provide additional resources to the SEC to oversee advisers.<sup>175</sup>

The IAA was concerned that establishing FINRA as the SRO for investment advisers would result in a complete overhaul of investor protections set forth in the Advisers Act, including fiduciary duty, requirements to disclose conflicts of interest, and restrictions on principal trading. The diversity of the investment adviser industry would make a rules-based SRO model, such as FINRA’s broker-dealer rules, unworkable. The IAA argued that the adviser community includes traditional asset-management firms, financial planners, wealth managers, advisers that are part of global financial institutions, and small advisers, and there is not sufficient commonality among the various types of adviser business

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168. See *Enhancing Investor Protection and the Regulation of Securities Markets—Part II: Hearing before the S. Comm. on Banking, Housing, & Urban Affairs*, 111th Cong. 196 (2009) (prepared statement of Barbara Roper, Dir. of Inv’r Prot., Consumer Fed’n of America).

169. *Id.* at 205.

170. *Id.* at 206.

171. *Id.*

172. *Id.* at 225 (prepared statement of David G. Tittsworth, Exec. Dir. & Exec. Vice President, Inv. Adviser Ass’n).

173. *Id.*

174. *Id.* at 225–26.

175. *Id.* at 226.



models.<sup>176</sup> In addition, the IAA asserted that the drawback of industry-funded regulation is that most investment advisory firms are small businesses with limited resources, and the costs of any SRO would impact all investment advisers, including thousands of these small advisory firms, with the ultimate costs passed on to investors.<sup>177</sup>

FINRA testified that it was uniquely positioned from a regulatory standpoint to build an oversight program for investment advisers quickly and efficiently.<sup>178</sup> “In FINRA’s view, the best oversight system for investment advisers would be one that is tailored to fit their services and role in the market, starting with the requirements that are currently in place for advisory activity.”<sup>179</sup> Differences in investor-protection standards for broker-dealers and investment advisers could be further dealt with by increased consistency in investor protections across financial services because “investors deserve a consistent level of protection no matter which financial professionals or products they choose.”<sup>180</sup>

Faced with these strongly expressed opposing views, Congress punted. Instead of settling these differences, Dodd-Frank mandated two related studies by the SEC regarding investment advisers, the Examinations Study<sup>181</sup> and the Harmonization Study.<sup>182</sup> The Examinations Study was required to address “the need for enhanced examination and enforcement resources for [the oversight of] investment advisers.”<sup>183</sup> This study demonstrated that the SEC seriously lacked the resources for the examination of SEC-registered advisers. The other study, the Harmonization Study discussed above, involved the broker-dealer exclusion to the definition of investment adviser; and the “effectiveness of existing legal or regulatory standards of care” for brokers, dealers, and investment advisers when providing personalized investment advice to retail customers, discussed above.<sup>184</sup> Dodd-Frank also required the Comptroller General to conduct a study on the feasibility of creating an SRO for advisers.<sup>185</sup>

Over the years, the SEC and the securities industry have experimented with a variety of different types of SROs, which are subject to considerable

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176. *Id.* at 220.

177. *Id.* at 225.

178. *See id.* at 53 (statement of Richard G. Ketchum, Chairman & CEO, Fin. Indus. Regulatory Auth.).

179. *Id.* at 55.

180. *Id.* at 166 (prepared statement of Richard G. Ketchum, Chairman & CEO, Fin. Indus. Regulatory Auth.).

181. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 914, 124 Stat. 1376, 1830 (2010) (codified as 15 U.S.C. § 80b-11 note (2012)) (mandating the Study on Enhancing Investment Adviser Examinations).

182. *Id.* § 913.

183. *Id.* § 914(a)(1); DIV. OF INV. MGMT., U.S. SEC. & EXCH. COMM’N, STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS I (2011) [hereinafter SEC EXAMINATIONS STUDY].

184. SEC HARMONIZATION STUDY, *supra* note 109, at i.

185. Dodd-Frank Act § 939E.

SEC oversight, including FINRA.<sup>186</sup> For better or worse, self-regulation is embedded in the framework of federal securities regulation, and it has long been used to leverage the SEC's scarce resources, especially with regard to examinations of securities industry participants. Unless Congress becomes willing to vastly increase the SEC's budget, or give the agency the authority to become a self-funded organization, the only realistic way to provide for the appropriate examination of advisers is to give this job to FINRA or to a new SRO.

Whether the best SRO for advisers is FINRA, a separate subsidiary of FINRA, or a newly organized and separate SRO is a difficult question. There are numerous reasons why it would be easier to put an SRO for advisers under FINRA's umbrella. FINRA already has a well-understood legal relationship to the SEC and it has the necessary infrastructure for the job. On the other hand, an SRO does depend on industry input and governance, and if the majority of advisers wish to establish a separate SRO, they should probably do so. There is nothing to prevent such a development other than resistance on the part of advisers to *any* SRO regulation.

I do not agree that the PCAOB is a good model for advisers because its board members are SEC-appointed and it is essentially a government agency, not an SRO.<sup>187</sup> Neither do I agree that a harmonized fiduciary standard would necessarily have to be rule-based. A rule-based regime is what the DOL has now crafted, and the industry is extremely unhappy with this development. Perhaps now that the industry is confronted both with the DOL's ideas about the fiduciary obligations of advisers and the SEC's apparent inability to either halt or alter the DOL's proposal, the prospect of an SRO for advisers will seem more appealing.

### III. SEC EXAMINATIONS AND ENFORCEMENT CASES

#### A. EXAMINATIONS BY THE OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

The SEC has long been lacking an adequately financed and effective examinations program for investment advisers. In the early 1990s, the SEC urged Congress to pass legislation imposing an annual fee on advisers based on the amount of assets under management in order to fund a greatly increased inspection cycle for small investment advisers.<sup>188</sup> Proposed legislation to this effect sparked a debate over the creation of a private right of action under the antifraud provisions of the Advisers Act, which the

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186. See Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 151 (2008).

187. See *Free Enter. Fund v. Pub. Co. Oversight Bd.*, 561 U.S. 477, 484–85 (2010).

188. S. 2266, 102nd Cong. § 5 (1992); H.R. 5726, 102nd Cong. § 4 (1992).

chairman of the SEC opposed.<sup>189</sup> Thus, this legislation never came to fruition. Dodd-Frank did not solve the problem of an underfunded SEC unit for examinations, but rather mandated another study in an attempt to fill this legislative void.

Dodd-Frank not only mandated the Examinations Study by the SEC on the need for enhanced examination and enforcement resources for investment advisers, but also set forth certain parameters for it.<sup>190</sup> The SEC was required to examine: first, “the number and frequency of examinations of investment advisers over the [five] years preceding the date of the enactment of [Dodd-Frank]”; second, the extent to which the designation of one or more SROs to augment the SEC’s efforts would improve the frequency of examinations; and third, “current and potential approaches to examining the investment advisory activities of dually registered broker-dealers and investment advisers.”<sup>191</sup> Also, the SEC was supposed to discuss “the regulatory or legislative steps . . . recommended or . . . necessary to address the concerns in the Study.”<sup>192</sup>

The Examinations Study discussed the work of the Office of Compliance Inspections and Examinations (OCIE) with regard to examinations of registered investment advisers over the six years prior to the release of the study. OCIE takes a risk-based approach to the examination process, identifying higher-risk advisers based on information in regulatory filings, assessments during past examinations, and other criteria such as tips. OCIE conducts three types of examinations: (1) high risk examinations; (2) cause examinations; and (3) special purpose reviews.<sup>193</sup> Routine examinations seem not to be part of OCIE’s work. The focus of OCIE’s examinations is to “(1) improve compliance; (2) prevent fraud; (3) monitor risk; and (4) inform regulatory policy.”<sup>194</sup>

The Examinations Study reviewed OCIE’s record of adviser examinations, and the results were shocking. The number of registered advisers had increased over the past six years and the number of OCIE staff had decreased.<sup>195</sup> Further, the assets of registered investment advisers had increased, correlating to the size and complexity of the operations of the advisers examined.<sup>196</sup> The results “would have been even more significant but for the increase in . . . OCIE staff between 2008 and 2010.”<sup>197</sup>

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189. See S. 2266, § 5; H.R. 5726, § 4; *Advisers Act Proposal Shouldn’t Include Private Suit Provision, Breeden Declares*, 24 Sec. Reg. & L. Rep. (BNA) 831 (June 12, 1992).

190. Dodd-Frank Act § 914(a)(2), 15 U.S.C. § 80b-11 note (mandating the Study on Enhancing Investment Adviser Examinations).

191. *Id.*

192. SEC EXAMINATIONS STUDY, *supra* note 183, at 1.

193. *Id.* at 5.

194. *Id.*

195. *Id.* at 8.

196. *Id.*

197. *Id.* at 10.

Nevertheless, in 2010, OCIE examined only 9 percent of registered advisers, putting the rate of examination for advisers at once every eleven years.<sup>198</sup> By contrast, FINRA examined 57 percent of its members in 2008, and 54 percent in 2009.<sup>199</sup>

The SEC has made a valiant effort to improve its examinations of investment advisers, but there are more than 10,000 investment advisers registered with the SEC and there are only about 450 examiners, accountants, and lawyers, spread throughout the twelve SEC offices, who are dedicated to the examination of investment advisers and investment companies for compliance with the securities laws.<sup>200</sup> One idea for dealing with this mismatch of SEC resources to the number of advisers requiring examinations is third-party audits of advisers.<sup>201</sup>

In 2014, OCIE focused on newly registered advisers such as private funds.<sup>202</sup> OCIE's examination priorities for 2015 focused on "examining matters of importance to retail investors and investors saving for retirement."<sup>203</sup> In June 2015, OCIE launched a multi-year Retirement-Targeted Industry Reviews and Examinations Initiative (ReTIRE).<sup>204</sup> Risk-based examinations conducted pursuant to this initiative will focus on: reasonable basis for investment advice and recommendations; conflicts of interest; supervision and compliance controls; and marketing and disclosure.<sup>205</sup> "As part of its examination sweep, the SEC is sending to financial advisers a 13-page information request" that focuses on adviser recommendations to roll over funds from a 401(k) to an IRA, fees charged, conflicts of interest, and supervisions and compliance controls.<sup>206</sup> According to Jason Roberts, Chief Executive of the Pension Resource Institute, the SEC's initiatives are part of a regulatory turf war. "You can certainly see that they're trying to step up their oversight of this area and

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198. *Id.*

199. Elisse B. Walter, Comm'r, U.S. Sec. & Exch. Comm'n, Statement on Enhancing Investment Adviser Examinations (Required by Section 914 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act) (Jan. 19, 2011).

200. *About Office of Compliance Inspections and Examinations: National Exam Program: Offices and Program Areas*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/ocie?Article/about.html> (last modified Mar. 4, 2014).

201. *See Third-Party Advisor Audits Could Be a Disaster: Norm Champ*, THINKADVISOR (Nov. 24, 2015), <http://www.thinkadvisor.com/2015/11/24/third-party-advisor-audits-could-be-a-disaster-nor>.

202. Marc J. Fagel & Leslie A. Wulff, *Private Funds: Preparing for Another Year in the SEC Crosshairs*, 48 REV. SEC. & COMMODITIES REG. 13 (2015).

203. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC. & EXCH. COMM'N, EXAMINATION PRIORITIES FOR 2015 1 (2015).

204. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC. & EXCH. COMM'N, RISK ALERT: RETIREMENT-TARGETED INDUSTRY REVIEWS AND EXAMINATIONS INITIATIVE 1 (2015).

205. *Id.* at 2–3.

206. Mark Schoeff Jr., *SEC Exam Questions Dive Deeply into Retirement-Account Advice*, INVESTMENTNEWS (Dec. 22, 2015, 1:56 PM), <http://www.investmentnews.com/article/20151222/FREE/151229968/sec-exam-questions-dive-deeply-into-retirement-account-advice>.

say that they have a handle on regulating it, and that it is not the vacuum that DOL has portrayed.”<sup>207</sup>

## B. ENFORCEMENT CASES

This stepped up focus on compliance by investment advisers also has resulted in a record number of enforcement cases.<sup>208</sup> “The Division of Enforcement’s Asset Management Unit has 75 professionals spread across all 12 SEC offices” and works closely with OCIE.<sup>209</sup> The 2014 OCIE program targeting new adviser registrants resulted in a fair number of enforcement actions on such issues as “expense allocation and undisclosed fees, asset valuation and misleading marketing materials.”<sup>210</sup>

Among the enforcement cases the SEC instituted in 2014 were the following:

*Lincolnshire Management*: The SEC charged an “investment advisory firm with breaching its fiduciary duty to a pair of private equity funds by sharing expenses . . . in a manner that improperly benefited one fund over the other.”<sup>211</sup> The two portfolio companies, which were acquired at different times, integrated a number of business and operations functions (i.e., human resources, marketing, and technology) and shared expenses that were generally allocated based on each company’s contributions to their combined revenue.<sup>212</sup> The SEC found, however, that in some cases, a portion of the shared expenses were misallocated or undocumented—for example, one portfolio paid the entire third-party payroll and 401(k) administrative expenses for the employees of both companies and some employees performed work that benefitted both companies, but their salaries were not allocated between the two.<sup>213</sup> As part of the settlement, the firm agreed to pay \$1.5 million in disgorgement, a \$450,000 penalty, and \$358,112 in prejudgment interest.<sup>214</sup>

*Transamerica Financial Advisors*: The SEC charged an investment adviser with failing to pass on appropriate breakpoint discounts to clients when they increased their client’s assets in certain investment programs and

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207. *Id.*

208. SEC’s FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases, U.S. SEC. & EXCH. COMM’N (Oct. 16, 2014), <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660>.

209. Jon Eisenberg, *SEC Enforcement Actions Against Investment Advisers*, K&L GATES 1 (Oct. 21, 2015), [http://www.klgates.com/files/Publication/4edea1a0-a6fc-42d8-8006-03a3e030ba8c/Presentation/PublicationAttachment/069ba046-0e19-4d2f-b3de-071c9f5df68e/GovEnforcement\\_Alert\\_10212015.pdf](http://www.klgates.com/files/Publication/4edea1a0-a6fc-42d8-8006-03a3e030ba8c/Presentation/PublicationAttachment/069ba046-0e19-4d2f-b3de-071c9f5df68e/GovEnforcement_Alert_10212015.pdf).

210. Fagel & Wolff, *supra* note 202, at 4.

211. Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges New York-Based Private Equity Fund Adviser With Misallocation of Portfolio Company Expenses (Sept. 22, 2014).

212. Lincolnshire Mgmt., Inc., Investment Advisers Act Release No. 3927, 2014 WL 4678600, at \*3–4 (Sept. 22, 2014).

213. *Id.* at \*4–5.

214. *Id.* at \*6.

also failed in some cases to aggregate related client accounts eligible for discounts.<sup>215</sup> The SEC stated that its examination staff had flagged the issue in an examination, in which the adviser had taken steps to address the aggregation issue after that examination, but that a subsequent examination revealed that the aggregation problem still existed, which led to the enforcement action.<sup>216</sup> The SEC charged that the “failures occurred because of inadequate policies and procedures at [the adviser’s] headquarters to implement the breakpoint policy, [in particular], the firm’s policies and procedures did not clearly delineate who was responsible for reviewing new account forms for account aggregation purposes,” and as a result, the firm “failed in certain instances to appropriately link accounts together to apply breakpoints in the billing process.”<sup>217</sup> The SEC also alleged that the adviser maintained two separate policy and procedure manuals, and that they “contained conflicting policies on the application of advisory fee breakpoints”—one making the breakpoint discounts mandatory and the other making them discretionary.<sup>218</sup> In connection with the action, the firm reviewed client records and paid reimbursement of \$553,624; as part of the settlement, it also paid an additional \$553,624 penalty.<sup>219</sup>

*Clean Energy Capital LLC*: The SEC brought charges against a private equity manager who used assets from nineteen private equity funds to pay more than \$3 million of expenses that the manager should have borne.<sup>220</sup> This was in addition to the management fees already being paid to the manager. The SEC charged that the manager failed to disclose the payment arrangement in fund offering documents, and stated that “[p]rivate equity advisers can only charge expenses to their funds when they clearly spell . . . out [those arrangements] for investors.”<sup>221</sup> The SEC also charged a number of other violations, including that the manager caused the funds to borrow money from the manager at unfavorable rates.<sup>222</sup>

After 2014, SEC enforcement actions against advisers became even more widespread. “In the first 10 months of 2015, [the SEC] brought over

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215. Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges Transamerica Financial Advisors With Improperly Calculating Advisory Fees and Overcharging Clients (Apr. 3, 2014).

216. Transamerica Fin. Advisors, Inc., Exchange Act Release No. 71,850, Investment Advisers Act Release No. 3803, 2014 WL 1320270, at \*3 (Apr. 3, 2014).

217. *Id.* at \*4.

218. *Id.* at \*5.

219. *Id.*

220. Clean Energy Capital, Securities Act Release No. 9551, Exchange Act Release No. 71,610, Investment Advisers Act Release No. 3785, Investment Company Act Release No. 30,926, 2014 WL 709469, at \*1–2 (Feb. 25, 2014); *see also* Press Release, U.S. Sec. & Exch. Comm’n, SEC Announces Charges Against Arizona-Based Private Equity Fund Manager in Expense Misallocation Scheme (Feb. 25, 2014).

221. Press Release, U.S. Sec. & Exch. Comm’n, SEC Announces Charges Against Arizona-Based Private Equity Fund Manager in Expense Misallocation Scheme (Feb. 25, 2014) (quoting Marshall S. Sprung, Co-Chief, U.S. Sec. & Exch. Comm’n, Enf’t Div., Asset Mgmt. Unit).

222. *Clean Energy Capital*, 2014 WL 709469, at \*1.

two dozen significant cases” against advisers.<sup>223</sup> These cases embraced a wide variety of issues. Undisclosed fees, use of fund assets to pay expenses, and undisclosed conflicts of interest were high on the list of wrongful conduct.<sup>224</sup> The SEC also brought cases with regard to improper valuations of illiquid assets and misrepresentations about fund performance and investment risk.<sup>225</sup> Among the enforcement cases the SEC instituted in 2015 were the following:

*Kohlberg Kravis Roberts & Co.*: The SEC charged a private equity adviser with a breach of fiduciary duty by misallocating more than \$17 million “broken deal” expenses to its flagship private equity funds.<sup>226</sup> In addition, it also charged the adviser with failure to adopt policies and procedures governing expense allocation practices.<sup>227</sup> The adviser settled this case, agreeing to pay more than \$14 million in disgorgement and a \$10-million penalty.<sup>228</sup> The adviser consented to the entry of a finding of violations of sections 206(2), 206(4), and Rule 206(4)-7 of the Advisers Act.<sup>229</sup>

*First Eagle Investment Management and FEF Distributors*: Pursuant to the SEC’s “Distribution-in-Guise” initiative, the SEC brought a case against an investment adviser for the improper use of fund assets to pay for distribution-related services.<sup>230</sup> The SEC alleged that FEF Distributors (FEF) entered into agreements with two financial intermediaries for their distribution and marketing services, making payments in addition to those required pursuant to a 12b-1 plan.<sup>231</sup> The SEC also alleged that FEF inaccurately reported that these expenses were for sub-transfer agency payments.<sup>232</sup> In a settled administrative proceeding, the respondents agreed to pay disgorgement of \$24,907,354 plus pre-judgment interest and a penalty of \$12.5 million, and to findings of violations of section 206(b) of the Advisers Act and provisions of the Investment Company Act.<sup>233</sup>

*Virtus Investment Advisers, Inc.*: The SEC instituted and settled proceedings against an adviser based on the inclusion in advertisements and

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223. Eisenberg, *supra* note 209, at 1.

224. *Id.* at 1–2.

225. *Id.* at 2; *see also* Press Release, U.S. Sec. & Exch. Comm’n, SEC Announces Enforcement Results For FY 2015: Results Include Significant Number of High-Impact and First-of-their-Kind Actions (Oct. 22, 2015).

226. Kohlberg Kravis Roberts & Co. L.P., Investment Advisers Act Release No. 4131, 2015 WL 3941621, at \*1 (June 29, 2015).

227. *See id.* at \*6.

228. *Id.* at \*7–8.

229. *Id.* at \*6, \*8.

230. First Eagle Inv. Mgmt., LLC, Investment Company Act Release No. 31,832, Investment Advisers Act Release No. 4199, 2015 WL 5528211 (Sept. 21, 2015).

231. *Id.* at \*3.

232. *Id.* at \*4.

233. *Id.* at \*8; *see also* Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges Investment Adviser With Improperly Using Mutual Fund Assets to Pay Distribution Fees (Sept. 21, 2015).

filings of false and misleading performance data.<sup>234</sup> The data had been prepared by a third party, but the SEC held that the adviser was ultimately responsible for verifying its accuracy.<sup>235</sup>

## CONCLUSION

Conflicts of interest are common in every fiduciary relationship in the financial services industry. Such conflicts are “material facts that investment advisers . . . must disclose to their clients.”<sup>236</sup> Informed consent from the client permits the adviser to continue the advisory relationship despite the conflict, but the “adviser’s failure to disclose conflicts of interest to clients subjects it to possible enforcement action.”<sup>237</sup>

A recent article summarized the different investment adviser conflicts as: investment adviser firm v. client; client v. client; employee v. client; employee v. investment adviser firm; and vendor v. client.<sup>238</sup> While some of these conflicts can be cured by full disclosure and client consent, others may be more difficult to manage or eradicate. Further, the DOL is concerned about some newer conflict areas, such as IRA rollovers, and the promulgation of its fiduciary duty rule may well impose new and more rigorous obligations on advisers. Also, it is unclear whether FINRA’s rules and standards meet some of the more rigorous ERISA standards, such as the requirement to continuously monitor a client’s investments.<sup>239</sup> Therefore, it is not surprising that the SEC has had such difficulty in fashioning a harmonized fiduciary duty standard for advisers and broker-dealers.

In the meantime, while the SEC and DOL work on harmonizing fiduciary duty rules, SEC examinations and enforcement will likely focus on investment adviser conflicts. OCIE announced that one of its top priorities for 2016 is protecting retail retirement assets.<sup>240</sup> It can be anticipated that one by-product of OCIE’s 2016 examinations of investment advisers will be enforcement actions. SEC Chair Mary Jo White focused on investment management as a key area of misconduct for enforcement in her

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234. *Virtus Inv. Advisers, Inc.*, Investment Company Act Release 31,901, Investment Advisers Release No. 4266, 2015 WL 7179719 (Nov. 16, 2015).

235. *Id.* at \*2.

236. Julie M. Riewe, Co-Chief of the Asset Mgmt. Unit in the Div. of Enf’t, U.S. Sec. & Exch. Comm’n, *Conflicts, Conflicts Everywhere—Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View* (Feb. 26, 2015).

237. *See id.*

238. Joshua Horn & Amit Shah, *Guidance on Conflicts of Interest for Investment Advisers*, PRAC. COMPLIANCE & RISK MGMT. FOR SEC. INDUSTRY, Jan.–Feb. 2015, at 21, 23–25.

239. *See Tibble v. Edison Int’l*, No. 13-550, slip op. at 6 (U.S. May 18, 2015) (ERISA fiduciary has continuing duty to monitor investments and remove imprudent ones).

240. “OCIE will continue several 2015 initiatives to assess risks to retail investors seeking information, advice, products, and services to help them plan for and live in retirement.” Press Release, U.S. Sec. & Exch. Comm’n, SEC Announces 2016 Examination Priorities: New Areas of Focus Include Liquidity Controls, Public Pension Advisers, Product Promotion, Exchange-Traded Funds and Variable Annuities (Jan. 11, 2016).



testimony to the House Committee on Financial Services in November 2015.<sup>241</sup> She stated that “the SEC has continued to bring actions addressing a wide range of issues, such as performance advertising, undisclosed conflicts of interest, compliance issues, and private equity fees and expenses.”<sup>242</sup> The implication of these remarks is that SEC policies on investment-adviser conflicts of interest will be developed through enforcement cases.

It therefore appears that the seventy-fifth anniversary of the Advisers Act is being celebrated by renewed emphasis on the law’s fiduciary duty provisions for the protection of retail and other investors through rulemaking by the DOL and SEC, as well as SEC enforcement cases. A basic problem with the regulation of the fiduciary duties of advisers is that advisers charge for their services, and they are not going to provide advice for free. This is the inherent conflict of interest that advisers have with their clients, and although it can be ameliorated by regulation, neither the SEC nor the DOL has the competence to determine what advice is in the best interest of the clients. The SEC has traditionally focused on fees charged by advisers, but suitability and skill at investment analysis is at least as important as low fees. As argued above, an SRO, rather than a government agency, is better suited to regulate these matters.

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241. *Examining the SEC’s Agenda, Operations, and FY 2017 Budget Request: Hearing Before the H. Comm. on Fin. Servs.*, 114th Cong. (2015) (testimony of Mary Jo White, Chair, U.S. Sec. & Exch. Comm’n).

242. *Id.*